

Electric Choice 22: With full retail restructuring, what data or studies are available regarding the impact of having a supplier of last resort or having no such supplier?

Executive Summary

Available data and studies show that:

1. All states that fully deregulated generation have a provider of last resort (POLR), or default supplier, or both. Competitive markets have generally proved to be inadequate or incomplete as a substitute for the utility's "obligation to serve" under regulated model so states have been forced to create systems to ensure the provision of these services under deregulation. POLR and default supplier are technically not the same, although some states and information sources use the terms interchangeably. There is considerable variation among states in terms of the role and details of POLR and default service.
 2. Selection and pricing of POLR are important yet very challenging to "get right."
 3. In some cases, state government has stepped in as the ultimate provider of last resort to procure power for end users in response to electricity supply shortages and/or significant price spikes.
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- 1. All states that fully deregulated generation have a provider of last resort (POLR), or default supplier, or both. POLR and default supplier are technically not the same, although some states and information sources use the terms interchangeably. There is considerable variation among states in terms of the role and details of POLR and default service.**

States that have deregulated generation have included policies to require a POLR or other default provider for residential customers and sometimes for small commercial customers. In a fully regulated model, the incumbent utility serves this role and has an obligation to serve customers in a non-discriminatory manner under regulated rates based on the utility's cost of service. Competitive markets have generally proved to be inadequate or incomplete as a substitute for this "obligation to serve" so states have been forced to create systems to select and price these services through mandates, auctions, or other mechanisms. This service is provided by the distribution utility or a competitive provider (or a provider affiliated with the distribution utility) with varying levels of state oversight of prices. POLR and default rates are not regulated by the state like a traditional utility in a fully regulated state. The state does, however, require power to be procured and available to customers who do not receive service from a competitive provider and there is typically some oversight over the selection and pricing process.

Technically, POLR service is different from default service (also referred to as standard offer or basic service):

- a. The POLR provides service to customers whose electric provider suddenly leaves the market due to bankruptcy or other issues; it has also been used for customers who do not pay their bill to a competitive provider as an interim step before the electric service is physically disconnected. It is intended to be permanent option in a deregulated generation but a temporary option for an individual customer while that individual selects a new provider. That is, customers are not expected to remain on POLR service for long periods of time.
- b. Default or standard offer service is for customers who have not selected a competitive supplier. Although default service was originally designed to be temporary and available over a five-to-ten-year transition period as the market developed, it has become a permanent feature of

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deregulated states, except in Texas. In deregulated states with low participation by residential customers, most customers take the default service.

Only one state, Texas, has phased out default service. Texas still has a POLR.

The specific role, pricing, and other aspects of POLR and default service vary considerably among states. It is most common to have the selection and pricing of this service through some sort of bidding or auction process that is overseen by state regulators. The following data sources or reports summarize details of POLR service in various states.

- United States of America Electric Energy Market Competition Task Force and the Federal Energy Regulatory Commission (June 5, 2006), Docket No. AD05-17-000, Report to Congress on Competition in the Wholesale and Retail Markets for Electric Energy (see pp. 6-8 and Chapter 4 for discussion on POLR and default service)
- Joseph Cavicchi and Andrew Lemon, *Power Procurement: What's In Your Mix?*, Public Utilities Fortnightly (November 2006)
- Annual Baseline Assessment of Choice in Canada and United States: 2012 Assessment of Restructured Electricity Markets (December 2012)
- SNL Electric Regulatory Reform
- Regulatory Research Associates, Regulatory Focus, RRA Topical Special Report, August 1, 2012
- Kenneth Rose, *State Retail Electricity Markets: How Are They Performing So Far?* Electricity Policy, (2012)
- John Kwoka, Restructuring the U.S. Electric Power Structure: A Review of Recent Studies, Report for American Public Power Association (November 2006)
- Public Sector Consultants, Electricity Restructuring in Michigan: The Effects to Date of PA 141 and Potential Future Challenges, 2006, pp. 14-15

2. Selection and pricing of POLR and other default providers are important yet very challenging to “get right.”

The data and reports referenced above generally conclude that the selection and pricing of the POLR and other default service are important in terms of their overall impact on the development of the market and potential competitors. The Annual Baseline Assessment of Choice in Canada and the United States (ABACCUS) ranks states based on progress in deregulating their electricity industry. The ABACCUS study contends that the design and implementation of default service “is the most significant single issue affecting the success of retail electricity restructuring in the residential sector.”¹ The ABACCUS report argues that default service should be phased out as part of the transition to full restructuring and default services should be very limited in scope with pricing that does not undercut competitors, thereby allowing new competitors to enter and remain in the market. Accordingly, only those states that have fully phased out default service (i.e., Texas) receive full points under the ABACCUS methodology. Default services have not been phased out in other states due in part to the various challenges with rates, low customer participation, and limited choices.

Available studies—and over a decade of actual experience with restructuring—show how it can be incredibly challenging for policy makers, regulators, and the market to “get it right” in terms of POLR and default services. That is, it is difficult to design and administer this service in a manner

¹ Annual Baseline Assessment of Choice in Canada and United States: 2012 Assessment of Restructured Electricity Markets, Produced by Distributed Energy Financial Group, LLC (December 2012)

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that balances various interests with respect to affordability for customers and the broader goals of competition.

In theory, default prices should be high enough to encourage new market entrants but not too high so as to avoid gouging customers who remain on this service. These objectives have been complicated by the fact that most states, including Michigan, included price caps or rate reductions on the default provider as part of restructuring so that residential customers (and small commercial, as applicable) would receive some benefit, and also to attempt to shield smaller customers from significant fluctuations in wholesale prices. Actual practice revealed that it is difficult to balance and sustain these various objectives—affordability, predictability, and market stimulation—particularly over time. Data show that:

- Rates of default service are, on average, more than rates in fully regulated states (see article by Kenneth Rose, 2012, referenced on page 2 above; for more in depth discussion, see Electric Choice Question 3).
- Rates of default service jumped dramatically in many restructured states after price caps or reductions expired, leading some states to re-regulate and even take more extreme actions. Other times, they were below wholesale market prices, making it difficult, if not impossible for competitors to enter or stay in the market.
- POLR rates, when designed as a true safety net as in Texas, are high due largely to the inherent risk of the fluctuating customer base (making it more expensive for the provider to procure power).
- While default service was designed to be temporary, it has, in fact, become permanent in most deregulated states.

Paul Joskow of the AEI-Brookings Joint Center for Regulatory Studies explains the challenges with pricing default service:

In many states[,] the regulated default service price was either set or eventually fell below the comparable cost of power in the wholesale market. In some cases, rising wholesale prices caused by higher gas prices erased or reversed the gap between the default price and the wholesale price. For example, in Pennsylvania PPL has a default price of 5.5 cents/Kwh for residential customers that is based on a formula defined when retail competition was initiated in Pennsylvania in 2000. The forward wholesale price for power delivered at PJM West for Calendar year 2006 (16 hours per day for six days per week) was about 8 cents/kWh on August 23, 2005. PPL's default price is not scheduled to rise to market levels until 2010. Obviously, ESPs [Electric Service Providers] will find it difficult profitably to buy power at 8 cents and sell it at under 5.5 cents to attract customers away from default service.²

Texas avoided some of the problems that occurred in other states because its transitional default service, known as the Price to Beat, and the POLR rates were indexed to natural gas prices (which strongly correlated with wholesale power prices given the predominance of natural gas generation). But these rates increased considerably as natural gas prices increased in the mid-2000s—much more so than they would have under Texas' prior regulatory structure, which allowed utilities to pass through actual fuel costs. Texas has also faced other problems, such as capacity shortages, which are

² Paul L. Joskow, AEI-Brookings Joint Center for Regulatory Studies, Markets for Power in the United States: An Interim Assessment, Working Paper 05-20, September 2005.

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a function of deregulation and may affect pricing of POLR over the long term. See Electric Choice Question 3 for additional discussion of rates in restructured states.

3. In some cases, states have stepped in as the ultimate provider of last resort.

When caps on default retail prices, combined with high wholesale prices, caused providers to go into bankruptcy in California and there was an “imminent threat of widespread and prolonged disruption of electrical power,” the state stepped in to actually procure power on behalf of end users. While California’s experience was extreme and exacerbated by power shortages and wholesale market manipulation, other states, including Illinois, also took on a power procurement role or steps to regulate prices in response to significant price spikes.

As mentioned above, Texas did not experience some of the challenges of other states. Nonetheless, the competitive bidding process to select POLRs with “fixed” prices as laid out in the state’s restructuring law failed with no bidders.³ As a result, state regulators had to intervene in order to effectively force entities to serve as POLRs and to establish the rates in an administrative proceeding (contested case hearings).

Going forward, it will be important to monitor rates for default providers and POLRs as risks associated with actual or potential supply shortages in capacity-constrained areas in Texas and in the East are reflected in pricing.

³ Attempts in Vermont and Connecticut to bid out electric service for low-income families were also unsuccessful. See Electric Choice Question 21 for detail.